




DEPARTMENT OF MENTAL HEALTH POLICY/PROCEDURE

SUBJECT FINANCIAL RESPONSIBILITY REQUIREMENTS FOR CONTRACTING WITH THE COUNTY OF LOS ANGELES DEPARTMENT OF MENTAL HEALTH	POLICY NO. 813.04	EFFECTIVE DATE 09/21/2009	PAGE 1 of 11
APPROVED BY:  Director	SUPERSEDES 412.21 09/21/2009	ORIGINAL ISSUE DATE 09/21/2009	DISTRIBUTION LEVEL(S) 1, 2

PURPOSE

- 1.1 To establish the financial responsibility requirements applicable for any non-profit or for profit non-government organizations (NGOs) that seeks to contract with the County of Los Angeles Department of Mental Health (DMH).
- 1.2 To identify which types of prospective contracts are waived from this Policy/Procedure and the reason for the waiver.

DEFINITIONS

- 2.1 **Conditions for eligibility to contract with the DMH:** A NGO shall demonstrate fiscal soundness and assumption of full financial risk before being eligible to contract with the DMH.
- 2.2 **Evaluation process:** The DMH evaluates financial soundness with the use of financial ratios based on actual and/or pro forma financial statements.

POLICY

- 3.1 A NGO must demonstrate fiscal soundness and assumption of full financial risk in order to contract with the DMH.
 - 3.1.1 A NGO must provide to DMH financial statements consisting of a balance sheet, an income statement, and a statement of cash flow, or Form 990 (for non-profit), Department of the Treasury, Internal Revenue Service (IRS) *Return of Organization Exempt from Income Tax*, or Form 1120 (for profit) *U S Corporation Income Tax Return*. The financial statements or IRS forms must show that the NGO meets DMH's solvency/working capital requirements.



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OR

- 3.1.2 A NGO that cannot demonstrate fiscal soundness because its actual financial statements or IRS form do not meet the DMH's solvency/working capital requirements, or has no available actual financial statements or IRS form may either submit:
- A. Corrective Action Plan (CAP) that would demonstrate future compliance with the DMH's solvency/working capital requirements, or
 - B. Pro forma financial statements consisting of a balance sheet, an income statement, and a statement of cash flow.
- 3.1.3 **Exemptions:** Prospective contract awards that have statements of work which do not include any requirements for the provision of mental health treatment services, and do not require any other type of direct client care and which restrict reimbursement to payment in arrears and are not Legal Entity Agreements are exempted from this Policy. The DMH does not require prospective contractors seeking such contracts to pass the Financial Responsibility Requirements in order to be qualified to bid in response to a contract solicitation. The exceptions to this Policy/Procedure are provided in *Attachment I Prospective Contractors Waived from the Financial Responsibility Requirements*.
- A. Exception means the prospective provider is not required to submit the financial documents specified in this Policy/Procedure.
 - B. The DMH Director will provide with each solicitation for services/activities a statement whether prospective contractors submitting a proposal under the solicitation are subject to the requirements set forth in this Policy/Procedure to submit the referenced financial documents as part of the proposal package to be provided to the DMH.

PROCEDURES



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4.1 **Section I: Submission of actual, CAP, or pro forma financial statements for evaluation of operating financial ratios.**

4.1.1 Actual financial statements:

- A. Submit the prior two (2) years' financial statements prepared by an independent Certified Public Accountant (CPA).
 - i. Such financial statements are to include the independent CPA's letter documenting internal control and/or other findings including those from federal single audits, if applicable.
 - ii. The financial statements are not to be more than 18 months old prior to their submission to the DMH.
 - iii. A NGO with annual operating revenues based on the following parameters shall submit either compiled, reviewed or audited financial statements:
 - a. Compiled statements - annual operating revenues averaging up to \$49,999.
 - b. Reviewed statements - annual operating revenues averaging from \$50,000 to \$499,999.
 - c. Audited statements - annual operating revenues averaging \$500,000 or more. The opinion of the CPA is to be included. If the opinion is qualified in any way, an explanation regarding the nature of the qualification is to be provided.
- B. Form 990 (for Non-Profit), Department of the Treasury, Internal Revenue Service (IRS) *Return of Organization Exempt from Income Tax*, or Form 1120 (for Profit) *U S Corporation Income Tax Return* may be substituted for the CPA prepared financial statements when the latter are not available.

4.1.2 Corrective Action Plan (CAP):

A NGO may submit a CAP if the analysis of its actual financial statements, or IRS forms fails to demonstrate the DMH's solvency/working capital requirements are met. The NGO must comply with the requirements set forth in Section III of this policy/procedure document.



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4.1.3 Pro forma financial statements:

A NGO may submit pro forma financial statements if actual financial statements or IRS form are not available, and/or the NGO is a start-up. The pro forma financial statements will be evaluated using the criteria specified in 4.1.4 below. The NGO must comply with the requirements set forth in Section III of this policy/procedure document.

4.1.4 Solvency/Working Capital grading/reviewing criteria for either actual or pro forma financial statements:

A. Quick ratio: purpose - to evaluate that the available cash, short-term investments and receivables are sufficient to meet current liabilities.

i. For pro forma balance sheet, short-term securities may be valued on a pro forma basis at current fair market value for purposes of this financial ratio evaluation. For actual balance sheet, any changes made on the value of securities/investments as originally shown on the financial statement(s) that will affect the result of financial ratio evaluation would require the NGO to provide a proof which is to be provided by the CPA that had originally prepared the financial statements.

ii. Formula: cash + short-term securities + accounts receivable + current liabilities.

iii. Criterion: must be fair or good.

a. Weak: <1

b. Fair: $\geq 1 \leq 2$

c. Good: > 2

B. Current ratio: purpose - to evaluate that the current assets are sufficient to satisfy current liabilities.

i. For pro forma balance sheet, short-term securities may be valued on a pro forma basis at current fair market value for purposes of this financial ratio evaluation. For actual balance sheet, any changes made on the value of securities/investments as originally shown on the financial



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statement(s) that will affect the result of financial ratio evaluation would require the NGO to provide a proof which is to be provided by the CPA that had originally prepared the financial statements.

- ii. Formula: current assets + current liabilities.
- iii. Criterion: must be fair or good.
 - a. Weak: <1
 - b. Fair: $\geq 1 \leq 2$
 - c. Good: > 2
- C. Expense/Income ratio: purpose - to evaluate the NGO's ability to generate sufficient income to meet its expenses.
 - i. For actual expense/income financial statements adjustment of expenses may be made for any non-cash expenses for purposes of this financial ratio evaluation. Non-cash expenses are depreciation and amortization unless otherwise authorized by the DMH.
 - a. Verifiable documentation must be provided to the DMH for any pro forma adjustments.
 - b. One-time events will be dealt with by the DMH on a case by case basis. The NGO must isolate and fully document the one-time event from the historical financial results of the NGO's ongoing operations, and explain the nature of the event to distinguish it as one-time and not as a customary routine recurring cost. If the NGO adequately identifies and documents the one-time event(s) then the DMH will exclude the one-time event from its expense/income ratio evaluation and will recalculate the expense/income ratio.
 - ii. Formula: (expenses before taxes - any non-cash expenses - any one-time event expense(s) \div gross income in the year of the financial statement(s)).
 - a. The NGO should inform DMH if any reserve/contingency transaction(s) occurred during the year had an impact on either the expense and/or revenue accounting records.



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The DMH will take into consideration any reserve/contingency transactions when calculating the Expense/Income ratio.

iii. Criterion: must be fair or good.

- a. Weak: > 1.0
- b. Fair: = 1.0
- c. Good: < 1.0

D. Tangible Net Asset requirement purpose - to evaluate longer term financial viability. Tangible assets mean total assets less intangible assets.

- i. Intangible assets are not physical in nature. The term intangible is applied for accounting purposes to all nonphysical property including organizational costs, leasehold costs, goodwill, patents copyrights, trade names, secret formulas, franchises, and licensing.
- ii. Tangible assets including short and long-term investments and real property may be valued on a pro forma basis at current fair market value for purposes of this financial ratio evaluation. Any changes made on the value of investments and fixed assets as originally shown on the actual balance sheet that will affect the result of financial ratio evaluation would require the NGO to provide proof which is to be provided by the CPA that had originally prepared the financial statements.
- iii. "Tangible net assets" means tangible assets less total liabilities.
- iv. Formula: (total assets - intangible assets) - total liabilities.
- v. Criterion: must be "pass".
 - a. Weak: Negative tangible net assets.
 - b. Pass: Positive tangible net assets.

4.2 Section II: Criteria to be eligible to contract:



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- 4.2.1 The NGO will be eligible to contract with the DMH when it demonstrates through its actual (i.e., history of operations) financial statements, IRS form, CAP, or pro forma financial statements that it has:
- A. The ability to deliver mental health services and/or activities;
 - B. A schedule of rates and charges that is financially sound;
 - C. The ability to achieve and maintain positive cash flow; and
 - D. The capability to assume full financial risk.

- 4.2.2 The NGO must provide the required financial statements identified in 4.1.1, A and B and demonstrate:
- A. Minimum ratings of "fair" for each of the three (3) grading/reviewing criteria in 4.1.4, A, B, and C, and a "pass" for D. *(Meet Solvency/Working Capital grading/reviewing criteria for either actual or pro forma financial statements)* are necessary to be eligible for contracting with the DMH.
 - B. Such ratings of "fair", "good" or "pass" may be after the application of the specified pro forma adjustments in 4.1.4, A.i., B.i., C.i., and D.ii,

4.3 Section III: Additional requirements for a NGO that uses CAP, or pro forma financial statements to demonstrate fiscal soundness and assumption of full financial risk:

- 4.3.1 These requirements are applicable for a NGO that either has financial statements or IRS form that do not satisfy the financial ratios requirements specified in the above 4.2.2 or one that has no available financial statements or IRS form.

- 4.3.2 **NGO has current CPA financial statements or Form 990/1120** specified in 4.1.1. However, those actual financial statements or IRS Form 990/1120 do not demonstrate the NGO has a minimum rating of "fair" or "good" for the quick, current and/or expense/income ratios, and/or a "pass" for the tangible net asset requirement in 4.1.4, A,



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B, C, and D. *(Meet Solvency/Working Capital grading/reviewing criteria for either actual or pro forma financial statements)* either before or after the pro forma adjustments in 4.1.4, A.i., B.i., C.i., and D.ii.

A. The NGO must self initiate and submit a CAP for DMH approval.

The CAP must show the necessary actions to be taken within one (1) year that will enable the NGO to demonstrate future compliance with the financial statement and financial ratios requirements set forth in 4.1.4, A, B, C, and D. The CAP requirements are:

i. The CAP must describe the specific actions the NGO has taken or will take to correct any deficiencies identified by the "weak" rating(s). The actions shall be reasonable in scope and breadth depending on the nature and degree of the deficiency. The CAP must also describe the time frame for completing the corrective action including a spreadsheet/schedule for submitting progress reports to the DMH. The timetable cannot exceed 12 months.

ii. The CAP must include the following:

- Demonstrate that any "weak" deficiency is only a temporary deficiency and will not impair the NGO's working capital or net assets.
- Preparation and implementation of an appropriate business plan that will correct the solvency deficiency within a reasonable period of time.
- Demonstrate to the DMH's satisfaction that an extended period of time not to exceed one (1) year is necessary and appropriate to correct the weakness in the financial condition.
- Demonstrate the NGO has the financial and administrative capacity to provide timely access to and continuity of care.
- A NGO with a CAP must advise the DMH within ten (10) business days if the NGO's experience or other events will materially alter the NGO's ability to remain compliant with the CAP.



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4.3.3 **NGO does not have the CPA financial statements or Form 990/1120** required in 4.1.1. This may be because the NGO is a start-up or has been in operation but never obtained CPA services or filed an IRS Form 990 or 1120.

A. The NGO must prepare and submit a Pro forma financial statements and comprehensive business plan for the operation of the NGO. The business plan is to precisely address the NGO's business, its goals, the services, financial resources (i.e., financial position), cash flow management practices, maintaining accounting records and any other pertinent information about the NGO's actual or proposed clinical and business practices. The following outline of a business plan can serve as a guide and should be adapted as necessary,

i. Introduction

- Give a detailed description of the business and its goals.
- Discuss the ownership and legal structure of the NGO.
- List the skills and experience that the NGO has with the delivery of required services, administrative, financial and management personnel.

ii. Financial Management

- Explanation of the source and amount of the initial working capital that is available to finance the services/activities to be rendered, and should include the number of months that this working capital will cover expenditures pending the receipt of payments for services/activities.
- Projected monthly income/expenditure statements for the first year of the proposed contract.
- Projected monthly cash flow statements for the first year of the contract.
- Pro forma balance sheet at year-end of the first year of the proposed contract that identifies the available current net assets (assets - liabilities).
- Projections are to be supported by a statement as to the facts and assumptions upon which they are based.



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4.3.4 **Grading Criteria** for Section III applicable NGOs (See 4.3). The following conditions shall apply for any NGO that is subjected to the conditions of this Section III:

- A. The DMH will apply the Solvency/Working Capital grading/reviewing criteria identified in 4.1.4, A, B, C, and **D** to the pro forma projections include in the business plan that is presented by the NGO. The ratings must minimally be "fair" for quick, current, expense/income ratios and "pass" for the tangible net asset requirement in order for the NGO to qualify for being eligible to contract with the DMH.
- B. If the NGO is awarded a contract, it must demonstrate to the DMH no later than April 30 of the initial contract year that it is meeting the requirements set forth in 4.1.4, A, B, C, and D. If the NGO fails to meet such requirements, the DMH lead manager for the NGO is to evaluate and recommend to the DMH Executive Management Team (EMT) the appropriate action to be taken which may be termination or non-renewal of the contract.

4.3.5 The NGO must submit quarterly status reports, or more frequent if requested to the DMH concerning the extent to which the NGO's actual operations are meeting the targets shown in the projected income/expenditure statements, cash flow worksheets, and balance sheet. No status reports are necessary when the NGO used actual financial statements to qualify under this financial responsibility requirement policy.

4.4 **Section IV: Financial Responsibility Requirements Summary Table.**

Please see Attachment II for the *Summary of Financial Responsibility Requirements Grading/Reviewing Criteria Table for Prospective Contractors*

ATTACHMENTS

[Attachment I Prospective Contractors Waived From Financial Responsibility Requirement](#)



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[Attachment II Prospective Contractors Waived From Financial Responsibility Requirement](#)

REVIEW DATE

This policy shall be reviewed on or before September 21, 2014.